



China and the Global Financial Crisis: Implications for the United States

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Summary

Over the past several years, China has enjoyed one of the world's fastest growing economies and has been a major contributor to world economic growth. However, the current global financial crisis threatens to significantly slow China's economy. Several Chinese industries, particularly the export sector, have been hit hard by crisis, and millions of workers have reportedly been laid off. This situation is of great concern to the Chinese government, which views rapid economic growth as critical to maintaining social stability. China is a major economic power and holds huge amounts of foreign exchange reserves, and thus its policies could have a major impact on the global economy. For example, the Chinese government has recently announced plans to implement a \$586 billion package to help stimulate the domestic economy. If successful, this plan could also boost Chinese demand for imports. In addition, in an effort to help stabilize the U.S. economy, China might boost its holdings of U.S. Treasury securities, which would help fund the Federal Government's borrowing needs to purchase troubled U.S. assets and to finance economic stimulus packages. However, some U.S. policymakers have expressed concerns over the potential political and economic implications of China's large and growing holdings of U.S. Government debt securities. This report will be updated as events warrant.

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China's Stake in the Current Crisis

China's economy is heavily dependent on global trade and investment flows. In 2007, China overtook the United States to become the world's second largest merchandise exporter after the European Union (EU). China's net exports (exports minus imports) contributed to one-third of its GDP growth in 2007. The Chinese government estimates that the foreign trade sector employs more than 80 million people, of which 28 million work in foreign-invested enterprises.¹ Foreign direct investment (FDI) flows to China have been a major factor behind its productivity gains and rapid economic growth. FDI flows to China in 2007 totaled \$75 billion, making it the largest FDI recipient among developing countries and the third largest overall, after the EU and the United States. A global economic slowdown (especially among its major export markets—the United States, the EU, and Japan) could have a significant negative impact on China's export sector and industries that depend on FDI flows. There are indications that the Chinese economy is already slowing down. Chinese real annual GDP growth slowed from 13.0% in 2007 to 9.0% in 2008. China's year-on-year fourth quarter GDP growth was 6.8%. Some analysts contend that China's real GDP growth from the third quarter of 2008 to the fourth quarter of 2008 on an annualized basis was near zero.² *Global Insight*, an international forecasting firm, projected in January 2009, that China's real GDP growth would slow to 6.3% in 2009.³ Some analysts contend annual economic growth of less than 8% could lead to social unrest in China, given that an estimated 20 million people seek jobs every year (including migrant workers that move to urban centers and high school and college graduates).⁴ According to the International Monetary Fund (IMF), China was the single most important contributor to world economic growth in 2007.⁵ Thus, a Chinese economic slowdown would not only affect China, but could also have global implications as well.

China's Exposure to the Global Financial Crisis

The extent of China's exposure to the current global financial crisis, in particular from the fallout of the U.S. sub-prime mortgage problem, is unclear.⁶ On the one hand, China places numerous restrictions on capital flows, particularly outflows, in part so that it can maintain its managed float currency policy.⁷ These restrictions limit the ability of Chinese citizens and many firms to invest their savings overseas, compelling them to invest those savings domestically, (such as in banks, the stock markets, real estate, and business ventures), although some Chinese attempt to shift

¹ *Invest in China*, September 10, 2007.

² Associated Press, "China's official data masks severity of slump, February 6, 2009.

³ *Global Insight, China*, January 27, 2009.

⁴ According to *Xinhua Net* (March 9, 2008), China's Labor and Social Security Minister Tian Chengping warned that the employment situation in China in 2008 was expected to be "very severe."

⁵ *IMF Survey Magazine: What the Numbers Show*, October 17, 2007.

⁶ Some analysts contend that China's policy of keeping the value of its currency low against the dollar and large purchases of U.S. debt may have been a contributing cause to the current global financial crisis.

⁷ China's central bank manages its currency (the renminbi or yuan) against a basket of major currencies (largely the U.S. dollar) by heavily intervening in international currency markets to maintain targeted exchange rates. See CRS Report CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte.

funds overseas illegally. Thus, the exposure of Chinese private sector firms and individual Chinese investors to sub-prime U.S. mortgages is likely to be small.

Moreover, Chinese government entities, such as the State Administration of Foreign Exchange, the China Investment Corporation (a \$200 billion sovereign wealth fund created in 2007),⁸ state banks, and state-owned enterprises, may have been more exposed to troubled U.S. mortgage securities. Chinese government entities account for the lion's share of China's (legal) capital outflows, much of which derives from China's large and growing foreign exchange reserves. These reserves rose from \$403 billion in 2003 (year end) to \$1.9 trillion as of December 2008.⁹ In order to earn interest on these holdings, the Chinese government invests in overseas assets. A large portion of China's reserves are believed to be invested in U.S. securities, such as long-term (LT) Treasury debt (used to finance the federal deficit), LT U.S. agency debt (such as Freddie Mac and Fannie Mae mortgage-backed securities), LT U.S. corporate debt, LT U.S. equities, and short-term (ST) debt.¹⁰ The Treasury Department estimates that, as of June 2007, China's holdings of U.S. securities totaled \$922 billion, making China the 2nd largest foreign holder of such securities (after Japan).¹¹ Of this total, \$467 billion were in LT Treasury securities, \$364 billion were in LT U.S. agency securities,¹² \$29 billion in LT equities, \$28 billion in LT corporate securities, and \$23 billion in ST debt.

If China held troubled sub-prime mortgage backed securities, they would likely be included in the corporate securities category and certain U.S. equities (which include investment company share funds, such as open-end funds, closed-end funds, money market mutual funds, and hedge funds) which may have been invested in real estate. However, these were a relatively small share of China's total U.S. securities holdings.¹³ China's holdings of Fannie Mae and Freddie Mac securities (though not their stock) were likely to have been more substantial, but less risky (compared to other mortgage-backed securities), especially after these two institutions were placed in conservatorship by the Federal Government in September 2008 and thus have government backing.

The Chinese government generally does not release detailed information on the holdings of its financial entities, although some of its banks have reported on their level of exposure to sub-prime U.S. mortgages.¹⁴ Such entities have generally reported that their exposure to troubled sub-prime U.S. mortgages has been minor relative to their total investments, that they have liquidated such assets and/or have written off losses, and that they (the banks) continue to earn high profit margins.¹⁵ For example, the Bank of China (one of China's largest state-owned commercial

⁸ For an overview of the China Investment Corporation, see CRS Report RL34337, *China's Sovereign Wealth Fund*, by Michael F. Martin.

⁹ China's large and growing reserves are largely the result of China's currency policy (which requires the government to intervene in currency markets to prevent the renminbi from appreciating), large levels of FDI, and large trade surpluses.

¹⁰ ST debt includes Treasury, agency, corporate, and equity debt with less than one year maturity.

¹¹ Although the Chinese government does not make public the dollar composition of its foreign exchange holdings, many analysts estimate this level to be around 70%. Based on this estimate, China's holdings of such securities may have risen to about \$1.3 trillion through the end of 2008.

¹² China was the largest foreign holder of U.S. agency debt, accounting for 29% of total.

¹³ According to the Treasury Department, China was not among the top 10 global investors of U.S. corporate mortgage-backed securities.

¹⁴ *Financial Times*, September 11, 2008.

¹⁵ According to Caijing.com, Chinese banks held \$670 million worth of bonds issued by U.S. investment bank Lehman (continued...)

banks) reported in March 2008 that its investment in asset-backed securities supported by U.S. sub-prime mortgages totaled \$10.6 billion in 2006 (accounting for 3.5% of its investment securities portfolio). In October 2008, it reported that it had reduced holdings of such securities to \$3.3 billion (1.4% of its total securities investments) by the end of September 2008, while its holdings of debt securities issued or backed by Freddie Mac and Fannie Mae were at \$10 billion. *Fitch Ratings* service reported that the Bank of China's exposure to U.S. sub-prime-related investments was the largest among Asian financial institutions, and that further losses from these investments were likely, but went on to state that the Bank of China would be able to absorb any related losses "without undue strain."¹⁶

However, Chinese banks are not immune to financial problems.¹⁷ There are several indicators that China's economy is slowing, which could present difficult challenges for the banking system in the years ahead, such as a sharp increase in non-performing loans. For example, the real estate market in several Chinese cities has exhibited signs of a bursting bubble, including a slow down in construction, falling prices, and growing levels of unoccupied buildings. This has increased pressure on the banks to lower interest rates further to stabilize the market, but has raised concerns that doing so could result in higher inflation.¹⁸ In addition, the value of China's largest stock market, the Shanghai Stock Exchange Composite Index, fell by 59% from January 1 to February 6, 2009. China's media reports that export orders in 2008 have declined sharply. From January to August 2008 toy exports were 20.8% lower than they were during the same period in 2007, and from January to July, more than half of China's toy exporters shut down.¹⁹ The Federation of Hong Kong Industries recently estimated that 2.5 million Chinese workers employed by Hong Kong firms in the Pearl River Delta region could soon lose their jobs.²⁰ On November 3, 2008, Chinese Premier Wen Jiabao warned that 2008 would be the "worst in recent times" for China's economy.²¹ In February 2009, the Chinese government estimated that 20 million migrant workers had lost their jobs due to the financial crisis.²²

China's Response to the Crisis

China has taken a number of steps to respond to the global financial crisis. On September 27, 2008, Jiabao reportedly stated that "What we can do now is to maintain the steady and fast growth of the national economy, and ensure that no major fluctuations will happen. That will be our greatest contribution to the world economy under the current circumstances."²³ On October

(...continued)

Brothers when it went bankrupt in September 2008.

¹⁶

Fitch Ratings, Press Release, January 24, 2008.

¹⁷ Although Chinese banks have claimed to have earned large profits in recent years, many analysts contend the banking system may be weaker than reflected in their reported data. A large share of bank loans go to state-owned firms and risk management remains relatively weak. A slowing Chinese economy could produce a new wave of non-performing loans.

¹⁸ *New York Times*, October 23, 2008.

¹⁹ *China Xinhua News Agency*, October 14, 2008.

²⁰ *South China Morning Post*, October 24, 2008.

²¹ *China Xinhua News Agency*, November 4, 2008.

²² *Xinhua News Agency*, February 6, 2009.

²³ *Chinaview*, September 27, 2008.

25, 2008, a Chinese Foreign Affairs official was reported by China's media as saying that China supported "effective and comprehensive reforms" of the global financial system. On October 30, another official stated: "In the future we are also willing, within the ambit of our abilities, to continue positively considering participating in a range of rescue plans." On November 14, China reportedly offered a \$500 million aid package to Pakistan. On November 15, 2008, Chinese President Hu Jintao participated in the summit meeting of the Group of 20 (G-20) countries in Washington, D.C., to discuss the current crisis. Many analysts have urged China to boost its funding to the IMF to help stabilize troubled economies.

In October, 8, 2008, China's central bank announced a cut (50 basis points) to its benchmark interest rate (and the reserve-requirement ratio), which coincided with rate cuts by the U.S. Federal Reserve and several other major central banks. China cut its rates again (by 27 basis points) on October 29 following the Federal Reserve's cut (by 50 basis points). China has also indicated plans to make greater efforts to shore up its own economy to promote greater domestic demand, boost living standards in the poorer sections of the country, achieve more balanced economic growth (e.g., lowering dependency on exports), and address a number of economic and social issues, such as boosting energy efficiency, lowering pollution, narrowing income disparities, and improving the social safety net (such as health care, education, pensions, and social security). A number of initiatives were announced by the government in October 2008, including plans to: implement a new economic stimulus package, including an acceleration of construction projects, new export tax rebates; tax and interest rate cuts on housing transactions; increased agriculture subsidies and new loans for small and medium-sized enterprises; and elimination of taxes on interest income from stocks and savings.²⁴ On November 9, the Chinese government announced it would implement a two-year \$586 billion stimulus package, mainly dedicated to infrastructure projects. The package would finance programs in 10 major areas, including affordable housing, rural infrastructure, water, electricity, transport, the environment, technological innovation and rebuilding areas hit by disasters (especially, areas that were hit by the May 12, 2008 earthquake).²⁵

China's Potential Role and Implications for the United States

Analysts debate what role China might play in responding to the global financial crisis, given its huge foreign exchange reserves but its relative reluctance to become a major player in global economic affairs and its tendency to be cautious with its reserves. Some have speculated that China would, in order to help stabilize its most important trading partner (the United States), boost purchases of U.S. securities (especially Treasury securities) in order to help fund the hundreds of billions of dollars that are expected to be spent by the U.S. government to purchase troubled assets and stimulate the economy.²⁶ Additionally, China might try to shore up the U.S. economy by buying U.S. stocks. On September 21, 2008, the White House indicated that President Bush had called Chinese President Hu Jintao about the financial crisis and steps the Administration was planning to take. An unnamed Chinese trade official was reported as stating

²⁴ China *Xinhua News Agency*, Special Report, Financial Crisis.

²⁵ China *Xinhua News Agency*, November 12, 2008.

²⁶ The U.S. Treasury Department reported on November 19, 2008, that in September 2008, China overtook Japan to become the largest foreign holder of U.S. Treasury securities, at \$585 billion.

that “the purpose of that call was to ask for China’s help to deal with this financial crisis by urging China to hold even more U.S. Treasury bonds and U.S. assets.” The official was further quoted as saying that China recognized that it “has a stake” in the health of the U.S. economy, both as a major market for Chinese exports and in terms of preserving the value of U.S.-based assets held by China” and that a stabilized U.S. economy was in China’s own interest.²⁷ Some contend that taking an active role to help the United States (and other troubled economies) would boost China’s image as a positive contributor to world economic stability, similar to what occurred during the 1997-1998 Asian financial crisis when it offered financial aid to Thailand and pledged not to devalue its currency even though other East Asian economies had done so, a move that was highly praised by U.S. officials.

On the other hand, there are a number of reasons why China might be reluctant to significantly increase its U.S. investments. One concern could be whether increased Chinese investments in the U.S. economy would produce long-term economic benefits for China. Some Chinese investments in U.S. financial companies have fared poorly, and Chinese officials could be reluctant to put additional money into investments that were deemed to be too risky.²⁸ Secondly, a sharp economic downturn of the Chinese economy would likely increase pressure to invest money at home, rather than overseas. Many analysts (including some in China) have questioned the wisdom of China’s policy of investing a large volume of foreign exchange reserves in U.S. government securities (which offer a relatively low rate of return) when China has such huge development needs at home. Many Chinese officials contend that maintaining strong economic growth in China is the most effective action China can take to promote global economic growth.

While additional large-scale Chinese purchases of U.S. securities might provide short-term benefits to the U.S. economy and may be welcomed by some policymakers, they could also raise a number of issues and concerns. Some U.S. policymakers have expressed concern that China might try to use its large holdings of U.S. securities as leverage against U.S. policies it opposes. For example, various Chinese government officials reportedly suggested on a number of occasions in the past that China could dump (or threaten to dump) a large share of its holdings in order to counter U.S. pressure (such as threats of trade sanctions) on various trade issues (such as China’s currency policy). In exchange for new purchases of U.S. debt, China would likely expect U.S. policymakers to lower expectations that China will move more rapidly to reform its financial sector and/or allow its currency to appreciate more substantially against the dollar.²⁹ Some analysts have suggested that China could choose to utilize its reserves to buy stakes in various distressed U.S. industries (such as autos). However, this could also raise concerns in the United States that China was being allowed to buy equity or ownership in U.S. firms at rock bottom prices, that technology and intellectual property from acquired firms could be transferred to Chinese business entities (boosting their competitiveness vis-a-vis U.S. firms), and that becoming a large stakeholder in major U.S. companies would give the Chinese government enormous new political influence in the United States.³⁰ U.S. policymakers in the past have sometimes opposed attempts by Chinese firms to acquire shares or ownership of U.S. firms.³¹

²⁷ *Inside U.S. Trade, China Trade Extra*, September 24, 2008.

²⁸ For example, in June 2007, China’s sovereign wealth fund bought \$3 billion worth of shares from Blackstone LP (a U.S. private equity firm) at \$31 each, but the value of those shares fell to below \$8 as of October 2008.

²⁹ China’s currency has appreciated by about 19% to the dollar since reforms were made in July 2005, but many U.S. policymakers contend that it remains significantly undervalued.

³⁰ Most Chinese firms that have been allowed to invest overseas are state-owned enterprises.

³¹ For example, efforts by a Chinese state-owned oil company (CNOOC) in 2005 to purchase a U.S. energy company (continued...)

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(Unocal) was widely opposed in Congress and eventually led the Chinese company to drop its bid. In 2007 a Chinese firm (Huawei) attempted to buy a stake in a U.S. technology company (3Com), but dropped its bid after a number of national security concerns were raised in a review by the U.S. Committee on Foreign Investment in the United States.